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CLEARY GOTTLIEB STEEN & HAMILTON LLP

ONE LIBERTY PLAZA
NEW YORK, NY 10006-1470
(212) 225-2000
FACSIMILE (212) 225-3999
WWW.CLEARYGOTTLIEB.COM

WASHINGTON, DC • PARIS • BRUSSELS
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Writer's Direct Dial: (212) 225-2440
E-Mail: jpeaslee@cgsh.com

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Internal Revenue Service
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Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
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Re: Proposed Compulsory Tax Regulations; Application to Active Businesses

Ladies and Gentlemen:

I am writing to comment on how Proposed Regulation § 1.901-2(e)(5)(iv) (the "Proposed Regulation") potentially applies to active businesses.

In brief, the Proposed Regulation would deny credits for foreign taxes paid in structured passive investment arrangements ("SPIAs"). An SPIA is an arrangement that meets six tests. One of them is that taxes be paid in respect of income of an SPV. The SPV must be passive, meaning that substantially all of its income must be derived form passive sources and substantially all of its assets must be held for the production of passive income.

The Proposed Regulation generally does a good job in limiting SPVs to passive vehicles. The requirement that substantially all of the income and assets of the entity be passive means that any substantial amount of active income or assets will avoid SPV status. I am concerned, however, that the proposed rules as currently written could apply to eliminate credits for taxes attributable to income from an active business that are not being used to support a tax benefit to a foreign party. The troublesome cases described below raise issues that are quite technical but given the results, they are worth some consideration. The problems I have encountered arise from the treatment of subsidiary investments, the way the inconsistent treatment test is written and reliance on section 954(h) in fashioning an active business exception for lending businesses.

Holding Company Case

Consider the following example:

Base Case. P, a domestic corporation, owns stock of FX, a controlled foreign corporation organized and doing business in country X. FX is the parent of a group of subsidiaries engaged in active businesses in X. Those subsidiaries are disregarded entities owned by FX for U.S. tax purposes. FX and its subsidiaries are all treated as corporations for X tax purposes.

FX issues a preferred security to an outside investor. The security is treated as equity under country X tax law. One buyer purchases an amount that represents 15 percent of the capital of FX. The buyer is a country X resident who is not taxable on dividend income in X. To reflect that benefit, FX pays income on the security at a reduced rate. The preferred security is treated as debt in the U.S.

FX makes regular distributions to P and P claims credits for X taxes under sectio 902.

Alternative. Same as above, except that the preferred security is also treated as equity for purposes of U.S. tax law, and FX is a partnership for U.S. tax purposes

I believe that under the Proposed Regulation, P could be denied credits for all (100 percent) of the X taxes imposed on FX and on its subsidiaries in both the Base Case and th Alternative.

Going through the Proposed Regulation as applied to the Base Case, the first thin to note is that there is a special definition of entity which includes disregarded entities. Accordingly, the SPV definition is applied to FX itself, not including the disregarded entity subsidiaries.

Turning to the six conditions listed in section 1.901-2(e)(5)(iv)(B), FX meets the passive income and assets test because the investments in the subsidiaries are passive and represent substantially all of its assets. Investments in subsidiaries are considered passive excep in the case of an issuance of common stock by a company that is a pure holding company (has substantially all of its assets in subsidiary equity). In the Base Case, FX issues a preferred security not common.[1]

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[1] The Proposed Regulation does not by its terms distinguish between preferred and common securities but rather asks if substantially all of the entity's opportunity for gain and risk of loss with respect to equity in a subsidiary is borne by the U.S. party or by the foreign counterparty. Presumably, in the example, substantially all of the risk and reward of the subsidiaries of FX would be considered to be borne by P. If that is not right, it would be helpful to have a clarification. Example 5 in the Proposed Regulation holds that a holding company is not an SPV when it issues stock to a U.S. party and a foreign party. The terms c the stock are not described, so it is not clear what was intended. It may be implied that they both acquired

There are foreign tax payments attributable to FX (note that they include foreign tax payments attributable to income of the subsidiaries as they are branches of FX under U.S. tax law).

P would be allowed a credit under section 902 for the taxes attributed to FX.

Those taxes exceed the taxes that would be imposed on P if it never had anything to do with country X (this condition seems always to be met).

The purchaser of the preferred security derives a foreign tax benefit.

The purchaser is unrelated to P and owns more than 10 percent of FX (according to country X standards).

There is inconsistent treatment because the preferred security is treated as equity in X and debt in the U.S. and that difference clearly could affect materially the credits and taxable income of P.

The example illustrates two potential problems with the SPIA definition. First, the rule treating income from active subsidiaries as active does not apply to a holding company that issues preferred securities. The exception for preferred securities was obviously adopted consciously, but I wonder if it is needed where the issuer has the benefits and burdens of the businesses of the subsidiaries? In that case, there does not seem to be much of a difference between conducting an active business directly and conducting it through subsidiaries. At any rate, the limitation has the practical effect of treating as passive companies that are parents of active groups.

Second, once FX is found to be an SPIA, all of the credits of FX are lost (including those attributable to its subsidiaries). There is no rule that limits the disallowed credits to the taxes that support the tax benefit realized by the foreign party. Thus, by issuing a security representing 15 percent of its capital, FX could place in jeopardy a disproportionately large amount of credits. Even if it were thought to be appropriate to apply the SPIA rules in this setting, the consequences seem overly harsh.

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common stock.

Note that if FX made loans to the subsidiaries and as a result less than substantially all of its income and assets consisted of equity in the subsidiaries, then it would seem that FX would fail to be a holding company (and would be an SPV) even if the security issued to the X investor were common stock. Income on those loans would seem to be passive because the Proposed Regulation overrides sections 954(c)(3) and (c)(6). One question is whether income on the loans would be counted at all given that they are loans between a disregarded entity and its owner. Ordinarily such a loan is ignored for U.S. tax purposes, and the passive income test is applied based on income for those purposes. On the other hand, disregarded entities are treated as entities for purposes of the SPV definition, so perhaps the loans would be recognized for this purpose. It would be helpful to clarify the point.

The Alternative set of facts in the example is the same as the Base Case, except that the preferred security is treated as equity in both country X and the U.S. and FX is a partnership in the U.S.

The application of the first five conditions would be the same as before. One might expect that the sixth condition would not apply because the preferred security is treated the same in X and in the U.S. However, there is a different inconsistency, which is that FX is a corporation in X and a partnership in the U.S. Depending on the facts and how the inconsistency condition is interpreted, the U.S. treatment of the difference in entity classification could materially affect (in one direction or the other) credits or income of P.

A threshold question is whether the inconsistent treatment of FX is an aspect of the arrangement. It can certainly be argued that it is not, as such treatment is not a key factor in producing a double benefit (in the U.S. and country X). On the other hand, the list of inconsistent aspects has differences in the tax status of the SPV as first on the list, and FX is the SPV and the issuer of the preferred securities. Without some specific guidance, it may be difficult to ignore the inconsistency on the ground that it is not part of the arrangement.

Assuming the inconsistent treatment of FX is part of the arrangement, it would presumably be necessary to compare the taxable income and credits of P assuming FX is a partnership (the U.S. treatment) with the income and credits of P assuming FX is a corporation (the country X treatment). A number of questions would arise in making this comparison. These include the following:

Is the relevant period the life of the arrangement, each year during the life of the arrangement, or something else? Income would flow through currently to P in a partnership but would not if FX were a CFC engaged in an active business unless there were distributions. (Note that the inconsistency test looks to whether income or credits are "affected" not whether income is lower or credits higher.) At some point, there could be a reconciliation of income amounts through additional dividend distributions or sales of FX stock. Would only "permanent" differences be taken into account? In comparing the partnership case with the corporate case, do you assume that the ultimate termination of the investment is through a taxable sale of stock or a section 332 liquidation? Credits for X taxes would be allocated to P under the partnership rules based on the allocation of the foreign income generating the credits in the current year, but under section 902 would be allocated based on earnings and profits and taxes from a multi-year pool. Would FX be deemed to come into existence as a corporation when the arrangement began so that there is no prior history?

Would any effect be given to the taxable income consequences of converting FX into a corporation (to test the effects of inconsistent treatment), such as the recognition of gains under section 367(a)? Suppose there would be significant section 704(c) allocations of income to P under the partnership rules that, of course, would not be made with a corporation. Would that difference be taken into account?

What about ancillary consequences for P of having a corporation versus a partnership? For example, suppose P's credits would be affected by different allocations o interest expense in computing the section 904 limitation depending on whether FX is a partnership or corporation?

To change the facts a little, suppose there were a second U.S. investor who owne 9 percent of the common stock and was claiming credits for its share of FX income. Converting to a corporation would "affect" that person's credits (eliminate them).

This is all a bit silly. The best approach would be to tailor the inconsistent treatment condition so that it is applied only to inconsistencies that go to the heart of the arbitrage benefit being sought.

Lending Businesses—Section 954(h)

The example above would apply to any kind of active business. There is an additional problem with how the active business definition applies to financial businesses, specifically lending businesses. The definition of passive income is based on section 954(c), which includes interest income unless an exception applies. The principal income of a lending business is interest. The only exception for interest earned in a lending business is section 954(h), which applies to income from the active conduct of a banking, financing or similar business that meets a number of requirements.

There are three potential problems with relying on section 954(h) in the context o the Proposed Regulation. They have to do with (1) specific requirements of section 954(h) that make sense in the context of an anti-deferral regime but not in assessing whether taxes are voluntary, (2) the different treatment of entities under section 954(h) and the Proposed Regulation, and (3) the potential for changes in section 954(h) based on policies relating to subpart F.

Idiosyncrasies of Section 954(h). Section 954(h) is part of subpart F and is therefore aimed at policing the anti-deferral policies of subpart F. Those policies are aimed at preventing U.S. controlled groups from avoiding U.S. tax by channeling readily moveable income of foreign subsidiaries through tax-haven jurisdictions having little connection with the underlying economic activity.

The requirements of section 954(h) fall broadly into two categories. First, incom must be derived from customer transactions. Second, the customer transactions must be related to the home country of the entity earning the income in a way that indicates that the income is not being diverted to a tax haven. Thus, for example, for lenders that are not licensed as banks i the U.S., at least 30 percent of the income must be from transactions with customers located within the CFC's home country. Further, income is not "qualified banking or financing income eligible for exemption unless it is treated as earned by the CFC in its home country for purposes of such country's tax laws.

Section 954(h) encourages CFCs to place themselves in a position to be taxed abroad if they wish to avoid subpart F and not be taxed on undistributed income in the United States. In the context of an anti-deferral policy, *more* foreign tax is better, because it shows tha the corporate group is not siphoning off income to tax havens.

By contrast, the Proposed Regulation are supposed to penalize taxpayers (by denying credits) when they pay more foreign tax than they really should, according to some standard. The policy in that setting is to encourage U.S. taxpayers to pay *less* foreign tax so tha the United States grants fewer credits. It would appear that the goal in that setting is the exact opposite of what it is under subpart F.

To illustrate, consider a taxpayer that has a corporate subsidiary FX that conduct an active lending business in country X, making loans to customers in X. FX wishes to engage in a financing transaction with a country X party that allows that party to get a tax advantage in country X. The benefit is not tied directly to the payment by FX of any particular amount of X taxes but rather depends on the fact that FX is considered a tax resident of X under X tax laws. FX books some of the loans it originates in X in a branch of FX in country Y, which imposes taxes at a very low rate. That branch is not very active; the employees and offices of FX are largely in country X. Nonetheless, under X law, FX avoids X tax on the loans booked in the Y branch because X does not tax income of a foreign branch. Despite its tax planning, FX still owes a substantial amount of X and Y tax and wants to credit that tax in the United States.

The parent of FX looks to the Proposed Regulation and discovers that income earned by the branch in Y is considered passive income. The section 954(h) exception is not available for that income because (among other things) the branch income is not treated as earned by FX in X under the tax laws of X. However, in terms of the policy underlying the Proposed Regulation, it would seem that FX should not be discouraged from reducing X taxes b shifting the loans to Y. Indeed, it should get a good citizenship medal from the Treasury! FX's tax planning has reduced X taxes paid to the bare minimum allowed by X tax laws, given the level of activity in X, and therefore reduced the credits claimed in the United States. It would seem that the key in applying the compulsory tax rule should be that FX is deriving income fro an active business that of necessity generates some foreign tax.

Suppose that through its country X offices, FX serves customers throughout a region. In a particular year, most of its business (more than 70 percent) comes from customers located in countries other than X. That fact would remove FX entirely from the protection of section 954(h), but it is hard to see what the location of customers has to do with whether the anti-arbitrage regulations should apply. Active is active.

Section 954(h) is sufficiently quirky so that it is unlikely to apply unless a taxpayer consciously wants it to apply and arranges its affairs to come within it. Thus, as a practical matter, the Proposed Regulation is more likely to result in the denial of credits for a group that is indifferent to subpart F than for one that wishes to take advantage of section 954(h to defer foreign earnings. It is not clear that this bias makes sense.

Treatment of Entities. Another reason why the section 954(h) exemption is unlikely to be available in many cases is the different treatment of disregarded entities in the Proposed Regulation and in section 954(h). Section 954(h) follows the normal Code rules, and accordingly, ignores disregarded entities. By contrast, the Proposed Regulation requires that disregarded entities be treated as separate entities. Many of the rules in section 954(h) apply to a CFC as a whole and could be failed if applied at the level of each legal entity comprising the CFC.

For example, section 954(h) requires that a CFC conduct substantial activity with regard to an active lending business. That rule is applied to the entity that is the CFC, so that if there are activities conducted through disregarded entities (a common fact pattern), they are counted. They would not be counted under the Proposed Regulation.[2]

Real operating businesses of the type that should be able to benefit from the active income exception are likely to have complex corporate structures for a whole host of commercial or regulatory reasons. They will not be able to rearrange those structures to meet the active business test in the Proposed Regulation applied on the basis of legal entities. Thus, the Proposed Regulation can be expected to apply to lending businesses in an uneven way based on factors that do not seem to have much to do with the underlying policy.

Potential for Changes. As currently written, section 954(h) has a limited life. It is set to expire at the end of 2008 (for calendar year taxpayers). It is not clear whether the section 954(h) exception in the Proposed Regulation refers to section 954(h) as in effect when the regulation is adopted or as in effect in the years applied, although the latter interpretation seems more likely. Given the very different policy behind the compulsory tax rules and subpart F, it does not seem to make sense to tie the fate of the active income exception in the compulsory tax regime to the continuing viability of section 954(h).

Recommendations

In light of the discussion above, I suggest you consider the following changes in the Proposed Regulation:

Allow activities of subsidiaries to be attributed to parents across the board. As long as equity holders of the parent are exposed to risks of the subsidiaries through the parent's ownership of the subsidiaries to the same extent as if the parent conducted the activities, it is not clear why there is a problem. If there is a particular abuse you are concerned about with parent-subsidiary structures, perhaps that could be targeted more directly.

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[2] For purposes of another rule, section 954(h)(3)(E) allows certain activities of a related party to be counted if that party is itself an "eligible controlled foreign corporation" and meets certain tests. The Proposed Regulation treats the particular entity being tested for SPV status as a controlled foreign corporation in applying section 954(h) but does not treat other affiliated entities as CFCs. Accordingly, it is not clear if this related party rule could apply.

Limit the foreign taxes for which credits are denied under the SPIA rules to those that are used twice (taken as credits in the U.S. and also used to support a foreign tax benefit). If you are concerned about administrability, maybe this could be a rule that allows a taxpayer to show that taxes are not being used twice. At the least this would mean that if a taxpayer gets caught by the SPV definition where a tax-advantaged financing represents a small part of its overall capital structure, the consequences would be proportionate to the size of the financing.

Consider limiting the inconsistent treatment factor to inconsistent treatment that allows the double use of taxes. This could be done by saying that an inconsistent aspect is part of an arrangement only if that aspect is created or used to achieve both an increase in credits or a reduction in taxable income under U.S. tax law for the U.S. party and a foreign tax benefit for th foreign counterparty. Also, change the "materially affect" language to require that the U.S. person have a material increase in credits or a material reduction in taxable income.

Sever the active business exception for lending businesses from subpart F. One approach would be to treat income as active if it would be active financing income under Treasury Regulation § 1.904-4(e)(2) and is not derived from the foreign counterparty. Another approach would be to say that income will not be considered passive if it is derived from transactions with customers or is income related or incidental to customer transactions (I am thinking particularly of hedging transaction). A customer relationship goes to the heart of distinguishing an active financial business from a passive one. It is used not only in section 954(h), but also (among other places) in distinguishing a dealer from a trader in section 1221(a)(1) and in deciding if a person is a dealer in securities under section 475 (an active lende is described as a person who regularly purchases loans from customers in the ordinary course of a trade or business).

I hope you find these suggestions to be helpful.

Very truly yours,

James M. Peaslee